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From:
Sent: Tuesday, September 22, 2009 5:25 PM
To:
Cc:
Subject: FW: Per our earlier conversation

This e-mail is to memorialize the previous verbal advice we provided to you.

LEGEND:

Parent 1 =

Group 1 =

Group 2 =

Sub 1 =

Sub 2 =

Sub 3 =

Sub 4 =

Litigants =

Period 1 =

Period 2 =

State X =

State Y =

Business A =

Business B =

Agreement =

Target =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Month 1 =

Month 2 =

Month 3 =

Date 1 =

Date 2 =

Date 3 =

Letter Ruling =

Activity X of Business B =

Item B =

<u>M</u> =

<u>N</u> =

<u>O</u> =

<u>P</u> =

<u>Q</u> =

<u>R</u> =

<u>S</u> =

FACTS:

Parent 1 is a publicly-traded company and the common parent of Group 1. Sub 1, Sub 2, and Sub 3 were subsidiaries of Parent 1 and all three had joined in the filing of the Group 1 consolidated returns during Period 1, which commenced in Year 1 and ended in Year 2. Parent 1 is incorporated under the laws of State Y. Sub 1, Sub 2 and Sub 3 (hereafter collectively referred to as the "Parent 1 Subsidiaries") were incorporated under the laws of State X.

Parent 1 was engaged in several different businesses, including Business A and Business B, directly and through its subsidiaries. Sub 1, Sub 2 and Sub 3 were engaged in Business B. In Year 2, all three Parent 1 Subsidiaries were merged into Parent 1 in transactions qualifying as Section 368(a)(1)(A) reorganizations. Thereafter, up until the spin off of Target, Parent 1 continued to conduct Business B (directly or through Target) that had been conducted by the Parent 1 Subsidiaries.

In Year 3, Parent 1 formed Target as a subsidiary under the laws of State X in contemplation of separating Business A from Business B. In Year 4, Parent 1, Target and Sub 4 entered into a plan of reorganization to effect the spin-off of both Target and Sub 4 in transactions anticipated to qualify as tax free reorganizations under Section 355. Under the plan, Parent 1 transferred to Target all assets related to Business B, and the stock of some wholly-owned subsidiaries. In exchange, Target issued its stock to Parent 1 and assumed the liabilities associated with Business B.

From Month 1, Year 4, through Month 2, Year 4, Target conducted Business B as a subsidiary of Parent 1 and was included in the Group 1 consolidated group. On Date 1, Year 4, Parent 1 spun-off Target. Thereafter, Target became a publicly-traded common parent of the Target and Subsidiaries consolidated group.

Following the spin-off of Target, Parent 1 continued to conduct other lines of business, including Business A, both directly and through its remaining subsidiaries. Target conducted Business B. The Service issued Parent 1 a Letter Ruling ruling that the formation of Target and the subsequent transfer by Parent 1 of the Business B assets to Target and spin-off of Target qualified as a tax-free reorganization under I.R.C. §§ 368(a)(1)(D) and 355.

In Month 2, Year 4, just before the spin-off was completed, a class action lawsuit by Litigants was filed against Parent 1 concerning the conduct of Activity X of Business B during Period 2. The lawsuit alleged that Parent 1 engaged in unlawful schemes and courses of conduct that induced persons to pay for Activity X of Business B in violation of state law and certain violations of common law. Litigants sought money damages, rescission of Activity X of Business B contracts and restitution for the money which Litigants paid pursuant to the contracts during Period 2. Period 2 includes all of Period 1 and several years thereafter, even years after Parent spun off Target.

In Month 3, Year 5, a court approved a class action settlement of Litigants' claims. The settlement agreement settled all claims arising out of the Litigants' allegations against Parent 1 concerning Activity X of Business B. In consideration for the settlement, Parent agreed to pay the Litigants the sum of $ M.

Parent 1 and Target agreed that the amount to be paid with respect to the settlement was an "Exclusive Target Contingent Liability," relating to Business B. As such, Target was responsible for the liability but entitled to reimbursement of Q percent of the amount in excess of $ O from Parent 1 and it was entitled to R percent of the amount in excess of $ O from Sub 4). Target accrued and paid $ N of the $ M settlement; Parent 1 paid $ P and donated Item B to the class of Litigants.

Based on the payment of $ N to the Litigants, Target desires to compute its tax liability with the benefit of I.R.C. § 1341 even though the amount previously included in Group 1's taxable income was earned and reported by the Parent 1 Subsidiaries in consolidated return years occurring prior to the formation of Target. Target argues that it is entitled to determine its tax liability using the tax treatment afforded by Section 1341 with respect to these previously-included-in-income amounts because it is the successor to the Parent 1 Subsidiaries based on Parent 1's transfer of the assets of Business B to Target and because Target paid $ N of the settlement amount based on its liability under state law as a transferee. In computing the amount of income included in the consolidated taxable income of Group 1 by the Parent 1 Subsidiaries under a claim of right during Period 1, Target relies solely on the amount of income from Activity X of Business B earned by the Parent 1 Subsidiaries during Period 1 and reported by Parent 1 on the Group 1 consolidated returns for those years.

LAW AND ANALYSIS

Issue 1. Section 1341

A taxpayer must satisfy the following three requirements to qualify for the tax benefits of Section 1341:

(a)(1) The taxpayer must have included an item in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to the item,

(a)(2) A deduction must be allowable to the taxpayer for the current taxable year because it was established after the close of the taxable year (or years) of income inclusion that the taxpayer did not have an unrestricted right to the item or portion thereof, and

(a)(3) The amount of the deduction must exceed $3,000.

Section 1341, when it applies, imposes on the taxpayer a tax for the current taxable year that is the lesser amount of:

(1) The income tax for the current tax year as computed with a deduction for the amount restored (Section 1341(a)(4)); or

(2) The decreases to the income tax for those prior taxable years, that result from making a tax redetermination for each of those prior tax years, based on excluding such restored items (or portion thereof) from the gross income of those prior tax years. Section 1341(a)(5).

Section 381

Section 381(a) provides that in the case of certain acquisitions of assets of a corporation by another corporation, the acquiring corporation succeeds to certain tax attributes of the transferor corporation listed in Section 381(c), determined as of the close of the day of distribution or transfer, subject to the conditions and limitations specified in Section 381(b) and 381(c). Section 381(c) does not expressly list the ability to use Section 1341 with regard to the acquiring corporation's restoration of an item previously taken into account by the transferor corporation in determining its (the transferor corporation's) gross income in a prior taxable year. Nevertheless, the Service has ruled that the acquiring corporation can avail itself of the Section 1341(a)(1) restoration treatment where the transferor corporation had in a prior tax year included the pertinent item in its gross income pursuant to a claim of right. The acquiring corporation may claim, pursuant to Section 381(c)(1), that this tax treatment has been transferred to it in connection with its assumption of an obligation, as described under Section 381(c)(16), of the transferor (or the distributor) corporation. See Rev. Rul. 71-496, 1971-2 C.B. 315 (the acquiring corporation in a Section 368(a)(1)(A) reorganization was entitled, under Section 381(c)(16), to deduct repayment of government subsidy payments previously received and reported by the acquired corporation and compute its tax under Section 1341 for the year of repayment).

A carryover of tax attributes from the transferor (or distributor) corporation to the acquiring (or distributee) corporation may occur in a corporate liquidation under Section 332 (Section 381(a)(1)) or in a transfer of corporate assets to which Section 361 applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D), (F) or (G) of Section 368(a)(1). However, Section 381(a)(2) provides this limitation: In the case of a reorganization under Section 368(a)(1)(D) or (G), the transfer of tax attributes occurs only if the requirements of subparagraphs (A) and (B) of Section 354(b)(1) are satisfied.

The requirements of Section 354(b)(1)(A) and (B) are satisfied only if:

1. the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and

> (2) The stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

Consequently, an acquiring corporation cannot invoke Section 381 to claim the benefit of the carryover of corporate tax attributes from the transferor corporation to the acquiring corporation in either a (D) or (G) reorganization where the property transfer results from a corporate division. Although the acquiring corporation cannot base a claim to the benefit of the carryover of corporate tax attributes on Section 381, that section does not prohibit it from claiming such benefit under another section of the Code or general tax principles. See Treas. Reg. § 1.381(a)-1(b)(3)(i), which states:

> Section 381 does not apply to partial liquidations, divisive reorganizations, or other transactions not described in subparagraph (1) of this paragraph. Moreover, Section 381 does not apply to the carryover of an item or tax attribute not specified in subsection (c) thereof. In a case where Section 381 does not apply to a transaction, item, or tax attribute by reason of either of the preceding sentences, no inference is to be drawn from the provisions of Section 381 as to whether any item or tax attribute shall be taken into account by the successor corporation.

Does Taxpayer Succeed to the Section 1341 Treatment?

During Period 1, the former Parent 1 Subsidiaries generated items of gross income attributable to Activity X of Business B. Prior to their merger into Parent 1, and while these subsidiaries were members of Group 1, these items of gross income were includible under Treas. Reg. § 1.1502-12 in each subsidiary's separate taxable income for purposes of computing Group 1's consolidated taxable income under Treas. Reg. § 1.1502-11(a)(1). When an item is included in gross income, the tax treatment under Section 1341 for each restored deduction is to be considered a tax attribute of each individual member rather than a tax attribute that attaches to the group as a whole.

The three Parent 1 Subsidiaries had included these amounts in their separate gross incomes before Parent 1's formation and subsequent spin off of Target. Subsequent to these inclusions, the three Parent 1 Subsidiaries merged into Parent 1. Parent 1 continued to conduct Business B that had been conducted by the Parent 1 Subsidiaries, but later formed Target by transferring to Target, among other things, the Business B assets. In exchange, Target issued its stock to Parent 1 and assumed the liabilities associated with Business B. Shortly thereafter, Parent 1 spun-off of Target in a transaction qualifying as a tax-free reorganization under Sections 368(a)(1)(D) and 355.

If the same corporation that had previously included the amount in gross income under a claim of right is the same corporation that is obligated to restore the amount, then that entity is entitled to the deduction afforded by the Section 1341 tax restoration treatment. Here, however, the three Parent 1 Subsidiaries were the entities that had previously included the amounts in gross income, and they are no longer in existence.

The potential for Section 1341 tax restoration treatment that had attached to each of these subsidiaries will vanish unless Section 381 or some other provision allows a carryover of the treatment to Parent 1 and/or Target. Target has represented that the three Parent 1 Subsidiaries merged into Parent 1 in transactions qualifying as Section 368(a)(1)(A) mergers. Assuming that the three tax free reorganizations did qualified as valid Section 368(a) reorganizations, and provided that Parent 1 assumed the refund obligations of the three Parent 1 Subsidiaries with respect to amounts that they included in their in gross incomes by reason of their claims of right, the Section 1341 tax restoration treatment will have carried over to Parent 1 as a result of the Section 368(a)(1)(A) merger transactions that qualify as transactions described in Section 381(a)(1) or 381(a)(2). See Rev. Rul. 71-496.

Target, and not Parent 1, however, is the entity required to restore Amount N, which amount represents the amount the three Parent 1 Subsidiaries previously included in their separate gross incomes under claims of right. Since Parent 1 is not required to restore Amount N, then, at least with regard to Amount N, Parent 1 may not avail itself of the deduction computed under the Section 1341 tax restoration treatment regime. So, although the Section 1341 tax restoration treatment carried over to Parent 1, the issue remains whether, with regard to Amount N, the Section 1341 tax restoration treatment again carries over, this time from Parent 1 to Target.

Target agreed to assume the liabilities associated with Business B, the business previously carried on by the Parent 1 Subsidiaries, in exchange for Parent 1 transferring to Target, among other things, Business B and the assets associated with Business B. Additionally, by court settlement, Parent 1 and Target were required to restore Amount M (Amount N is included in this amount) to the Litigants. Moreover, Parent 1 and Target had entered into Agreement, which established that these court-settled liabilities, at least to the extent of Amount N, are Exclusive Target Contingent Liabilities. Target was therefore legally bound to restore, and did restore, Amount N to the Litigants. Even assuming Amount N represents the collective amounts attributable to Activity X of Business B that the Parent 1 Subsidiaries included in their gross incomes, and that these includable amounts satisfied Section 1341(a)(1)'s requirement that an item have been included in gross income in a prior taxable year or years on account of the fact that the three Subsidiaries of Parent 1 had an unrestricted right to these amounts, the question nonetheless is whether Target may take advantage of the benefit of the deduction for Amount N afforded by the Section 1341 tax restoration treatment?

Did the Section 1341 tax restoration treatment carry over to Target as a result of its assuming the liabilities associated with Business B in a divisive Section 368(a)(1)(D) reorganization? Target answers this question in the affirmative, arguing that it is the successor to the Parent 1 Subsidiaries based on Parent 1's transfer of the assets of Business B to Target and because Target paid Amount N of the settlement amount based on its liability under state law as a transferee. We agree that Target is entitled to the benefit of a deduction for Amount N, but not for the reasons urged on us by Target.

Target acquired only the Business B assets from Parent 1, and not substantially all of Parent 1's assets, in the Section 368(a)(1)(D) reorganization resulting in Target's formation. This transaction, however, constituted a divisive, not an acquisitive, D reorganization. For Section 381 to apply to the transfer of tax attributes to a transferee corporation when, as here, the transferee corporation was formed as a result of a divisive D reorganization, the requirements of Section 354(b)(1)(A) and (B) must be satisfied. Section 381(a)(2). Because Parent 1 did not transfer "substantially all" of its property to Target, the requirements of Section 354(b)(1)(A) were not satisfied and, therefore, Target may not claim the carryover of tax attributes under Section 381. This latter conclusion does not end the analysis, however.

The consolidated return regulations do not expressly address the application of Section 1341. Treas. Reg. § 1.1502-80 provides that the Code (which, of course, includes Section 1341), or other law, shall be applicable to the group to the extent the regulations do not exclude its application. Moreover, Treas. Reg. § 1.1502-80(a) provides that to the extent other rules are not excluded or modified by the consolidated return provisions, they will still operate.

As noted above, Treas. Reg. § 1.381(a)-1(b)(3)(i) leaves open the possibility that a corporation that acquires the assets of another corporation as a successor of the transferor may succeed to a tax attribute of the corporation whose assets are acquired, notwithstanding that the acquisition satisfies neither Section 381(a)(1) nor Section 381(a)(2). Here, because Parent 1 continued to exist after the formation of Target, Target is not a successor corporation to Parent 1 under state law. Therefore, Target cannot avail itself of the language of Reg. § 1.381(a)-1(b)(3)(i). Moreover, because it is not a successor to Parent 1, we conclude that Target is not entitled to compute its tax liability under the Section 1341 tax restoration treatment regime. Once again, however, this latest conclusion does not end the analysis. We must still determine whether Target may nonetheless deduct Amount N that it paid to the Litigants. We conclude that it is entitled to deduct Amount N.

If a transferee corporation's payments of assumed liabilities could have been deducted by the transferor corporation had they been made before a § 351 exchange, the transferee is entitled to a deduction for the amount of the payments. Rev. Rul. 80-198. This rule applies not only to fixed liabilities, but also to contingent liabilities. Rev, Rul. 95-74. This rule is subject to two limitations: (1) There must be a valid business purpose for the transfer of the liabilities, and (2) the liabilities must be transferred together with their related receivables, and both must have arisen in the ordinary course of business and must not have been accelerated or prepaid for a tax-avoidance purpose. Although the transaction here is a Section 368(a)(1)(D) reorganization, it also qualifies under Section 351. Parent 1 has received favorable rulings that the exchange of the Business B assets for Target's stock and Target's assumption of the Business B liabilities constituted a valid, tax-free exchange under § 368(a)(1)(D) of the Code. Moreover, Parent 1's stated purpose in transferring the Business B assets and liabilities to Target was to separate Business B from its other businesses, this alone is a substantial business reason for the transaction itself. Furthermore, there are no facts indicating that Parent 1 had any tax avoidance motive for entering the transaction.

We conclude that Target, in assuming these liabilities associated with Business B, which were transferred together with the Business B assets in a transaction that qualifies as tax free under both Section 368(a)(1)(D) and Section 351, is entitled under the holdings and rationales of Rev. Ruls. 80-198 and 95-74, to a deduction for Amount N that it paid to the Litigants pursuant to the court-approved settlement since Parent 1 did not deduct any amounts associated with the assumed liabilities prior to the transfer to Target. The last remaining question, therefore, is whether Target is entitled to deduct this amount as an ordinary and necessary business expense under Section 162?

Section 162 of the Code provide a deduction to a taxpayer for business expenses taxpayer incurs and pays. In transactions qualifying as transfers under Section 351 and nonacquisitive Section 368(a)(1)(D) reorganizations, where the contingent liabilities of a transferor corporation are assumed by the acquiring corporation, the acquiring corporation is allowed to deduct the liabilities when they mature or are paid. The deduction is premised on the acquiring corporation being treated as having stepped into the shoes of the transferor with respect to the liabilities.

Accordingly, to the extent that the liabilities Target assumed were incurred in the ordinary course of business by the Parent 1 Subsidiaries and were associated with the Business B assets Parent transferred to Target in a Section 368(a)(1)(D)/351 transaction, Target may deduct as ordinary and necessary business expenses under Section 162 Amount N it paid to extinguish these contingent liabilities to the extent such amounts would otherwise have been deductible by Parent if not assumed by Target.

Please call at if you have any further questions.